

**EXECUTIVE
BOARD
MEETING**

SM/21/111

Correction 1

July 6, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Democratic Republic of Timor-Leste—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/111 (6/23/21) have been provided by the staff:

**Mischaracterizations
of the Views of the
Authorities**

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**Factual Errors Not
Affecting the
Presentation of
Staff's Analysis or
Views**

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Questions:

Mr. Lopez Murphy, APD (ext. 37647)

also welcome, which could help improve the ability to properly target social assistance, reduce fraud, and eliminate duplication of payments.

Authorities' Views

24. They concurred with staff recommendations on the need to shift focus towards fiscal sustainability once the pandemic is over. While they underscored that frontloading government spending is warranted to build basic infrastructure and diversify the economy, they also acknowledged the tradeoffs and the adverse consequences of depleting petroleum wealth and putting fiscal sustainability at risk. The authorities plan to adopt fiscal reforms to mobilize domestic revenue through introduction of the Value-Added Tax and a revised tax procedure code. In addition, the recent implementation of program-based budgeting will facilitate the prioritization of government spending. The [Ministry of Finance](#) also agreed on the need to improve the cost-benefit analysis of public investment projects, and to review the autonomous agencies that do not generate their own revenue.

25. They emphasized ongoing efforts to improve public financial management. Ongoing reforms aim to: (1) increase the stability of the budget by introducing a strong multi-year element and connecting it to the Multiannual Strategic Plan; (2) increase predictability by establishing a Medium-Term Fiscal Framework, approved and revised annually by Parliament; (3) increase transparency by overhauling budgeting and reporting and make it more frequent; and (4) increase comparability by adopting a chart of accounts and budget classifications based on international standards.

C. Structural Reforms to Bolster Medium-Term Growth Prospects

26. A number of structural barriers need to be lifted to unleash the country's growth potential. Human capital gaps in terms of the contribution of health and education to the next generation of workers are significant. The agriculture sector employs a large fraction of the labor force, but its productivity is low (Figure 5, bottom right) and the country relies heavily on food imports. There are several impediments to private investment, including restricted access to credit, obstacles to doing business, weak governance, and limited digital infrastructure (Figures 5 and 6). Low female labor force participation (Figure 7, bottom right) limits the contribution from labor.

27. Government policies should prioritize strengthening human capital formation and higher productivity in the agricultural sector.

- Spending in health and education accounts for only 16 percent of the 2021 budget and should be expanded in future budgets. Investing in human capital is essential to develop a labor force able to adapt to future job opportunities and achieve economic diversification. In 2020, the Human Capital Index for Timor-Leste stood at 0.45, which means that a worker of the next generation in the country, will be only 45 percent as productive compared to what would be the case under the benchmark of complete education and full health.

41. They are confident that the new anti-corruption law will help strengthen their fight against corruption. Efforts to conduct anti-corruption campaigns to raise public awareness, including in schools, are ongoing. However, the Anti-Corruption Commission highlighted human and financial resource constraints as key impediments to effective oversight and enforcement. They are implementing the second cycle of its United Nations Convention Against Corruption and expect to complete it by end-2021.

42. They acknowledged the need for improving the business environment, including through digitalization. They plan to: (1) streamline business registration and licensing, including by moving towards electronic certification; (2) strengthen the judicial system by developing extrajudicial means of dispute resolution, such as arbitration and mediation; and (3) transform internet connectivity by installing a submarine fiber-cable through Australia's northern territory to replace slow connection via satellite.

43. They agreed that structural reforms combined with fiscal consolidation are warranted to strengthen the external sector position. They nonetheless emphasized that improving competitiveness and diversifying the economy would take time. They underscored the importance of a stronger agricultural sector to increase commodity exports such as coffee and reducing food imports, to help close the current account gap.

44. They will promote the development of the tourism sector to support the economic recovery. In 2021, they will develop a new tourism policy and master plan and want to develop eco-tourism, combining accommodation with coffee and rice fields.

45. They emphasized that the modernization of the payment system, including via digitalization, has enhanced access to financial payments services and promoted a stable financial sector. The central bank is simultaneously focusing on financial literacy programs in elementary schools and launched the "Digital Village Program" to enhance safe financial inclusion. However, weaknesses in the collateral regime, contract enforcement and in credit registry information were noted as significant obstacles to credit expansion, especially to businesses.

46. They acknowledged that recent floods point to the need to enhance their disaster management strategy. They see a case for shifting towards climate-resilient infrastructure, strengthening the contingency fund, and starting territorial planning to identify and develop an integrated plan for urban and housing development, especially along riverbanks.

47. The regime of official dollarization has contributed to macroeconomic stability. Nonetheless, the central bank will review the advantages and disadvantages of the current regime versus alternative regimes.

48. The central bank is taking steps to strengthen the AML/CFT framework. The central bank introduced a new threshold for money transfer operators and e-wallet providers to report cash transactions over \$150,000 to the Financial Information Unit. The central bank has also implemented new supervisory tools to assess financial institutions' compliance with AML/CFT requirements.